

**Economic and Social Council**Distr.: General
26 May 1998

Original: English

Substantive session of 1998

New York, 6-31 July 1998

Item 13 (d) of the provisional agenda*

**Economic and environmental questions: international
cooperation in tax matters****Eighth meeting of the Ad Hoc Group of Experts on
International Cooperation in Tax Matters****Report of the Secretary-General****Contents**

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* E/1998/100



Introduction

1. As requested by the Economic and Social Council in its decision 1996/299 of 25 July 1996, the eighth meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters was held at the Palais des Nations, United Nations Office at Geneva, from 15 to 19 December 1997.

2. The Group of Experts observed that the increasing sophistication of the world economy presented significant challenges to the tax systems of the world. The development of international capital markets and transnational business had created a need to forge national, bilateral, multilateral and collective approaches to such important issues as international transfer pricing and the transfer of technology.

3. The increasing focus on international trade as manifested by the establishment of the World Trade Organization has created additional incentives to reduce, *inter alia*, tax-related barriers to exchanges of goods and services and international capital movements. Similarly, the emergence of transitional economies has necessitated greater efforts towards mobilization of domestic financial resources for development purposes and placed heavy emphasis on formulation of appropriate tax policy, improvement in tax administration and expertise in dealing with intricate problems in international taxation.

4. The work of the Group of Experts formed part of advisory services to the Secretary-General on the processes of double taxation avoidance, preventing international tax evasion and avoidance and strengthening financial resources mobilization with a view to promoting sustainable socio-economic development and improving international income allocation.

5. The eighth meeting of the Group of Experts was attended by a large number of experts and observers. The agenda was based on recommendations made at the seventh meeting, as well as on the deliberations produced and suggestions made during the informal discussions of the Steering Committee, the successor of the preparatory subgroup.

6. The informal discussions of the Steering Committee took place at the Palais des Nations, Geneva, on 11 and 12 December 1997 and concluded with the adoption of the proposed agenda, as contained in document ST/SG/AC.8/1997/L.1, which read as follows:

1. Opening of the meeting.
2. Remarks by the Director and Secretary of the Group.

3. Election of officers.
4. Adoption of the agenda and organization of work.
5. Updating of the United Nations Model Double Taxation Convention between Developed and Developing Countries and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries.
6. New financial instruments.
7. Transfer pricing.
8. Tax havens, with special reference to exchanges of information.
9. Other matters.
10. Arrangements for the ninth meeting.

7. Both the informal discussions of the Steering Committee and the Group of Experts at large examined the proposal for a series of training seminars in international taxation for tax administrators made by several countries and strongly recommended to the Secretary-General to proceed with the organization thereof.

8. It was decided that, subject to availability of extrabudgetary funds, the United Nations would arrange six interregional workshops to improve the practical technical skills of tax administrators in developing and transitional economy countries in international taxation, including practical methods and strategies for combating tax evasion.

9. The essence of the discussions on the main items in the agenda for the eighth meeting of the Groups of Experts is elaborated in the following paragraphs.

I. Tax havens, with special reference to exchanges of information

10. The Group of Experts observed that tax havens represented threats to the tax systems of both developed and developing countries and, hence, that the tax haven issue should be viewed as a cooperative effort between developed and developing countries and transitional economy countries. Tax havens compromise the principle of tax neutrality because they cause tax considerations to affect investment choices. Moreover, technological advances that facilitate immediate transfer of funds into tax havens, such as Internet commerce and electronic banking, have also contributed to their growing utility to tax evaders.

11. Several countries have adopted defences against tax haven activities, including controlled foreign corporations and foreign investment funds legislation. Many tax havens have provided bank secrecy and confidentiality rules which make it difficult for other countries to prove adequately the existence of tax fraud and other illicit activities. With a view to disclaiming overt complicity in such illegal activities, certain tax havens have come round to exchanging some tax information.

12. Although the concept of tax haven could not be defined precisely, it was noted that a tax haven possessed some of the following characteristics, namely:

- (a) Low or zero effective tax rate;
- (b) An unwillingness to share information;
- (c) A lack of transparency;
- (d) Absence of real business activity;
- (e) A special regime clearly demarcated from the domestic economy.

13. The Group of Experts agreed that it was the effective rate of tax and not the nominal rate that determined whether a country had the low tax or no-tax characteristic of a tax haven. However, developing countries offering extensive tax incentives resulting in low or negligible effective tax rate could not be considered tax havens.

14. In many tax haven countries, unpublished rulings erode the tax base, tax rates are varied to suit the taxpayers by private negotiations or the law as enacted is simply not enforced, with the result that it is the practical application of the law and not the nominal terms thereof that proves lack of transparency, which is one of the troublesome characteristics of the tax haven country.

15. The low or no-tax feature of a tax haven facilitated avoidance of taxation worldwide on income from sources in other countries. Tax havens were capable of shifting funds to their tax jurisdictions without shifting economic activities to their respective countries. The Group of Experts noted that although use of tax incentives should not be considered a tax haven characteristic, the low or no-tax regime resulted in unhealthy tax competition for attracting foreign investment. There was a need to arouse world consciousness in order to counter such undesirable tendencies.

16. The Group of Experts unanimously agreed that lack of access to tax information was a tax haven characteristic. The lack of access to information may stem from bank secrecy laws, other laws protecting the confidentiality of financial information, or laws facilitating issuance of bearer bonds and shares.

17. It was observed that the best way to facilitate access to tax information was through bilateral tax treaties with provisions for exchange of information or separate international agreements on information exchanges. These provisions should deal explicitly with bank secrecy laws of contracting countries. It may also be desirable to urge countries to abandon laws and practices that are harmful to the tax systems of other countries.

18. Some countries had been able to obtain information on transactions in tax haven countries by indirect means, such as through provisions in the tax laws requiring resident individuals and corporations to disclose all records and documents to the tax administration. These records could reflect transactions in tax haven countries as well. The tax laws may also empower the tax authorities to compel the taxpayer to produce documents pertaining to the foreign parent corporation of the domestic subsidiary one.

19. Where a taxpayer is proceeded against for a criminal action in a tax fraud case, the court may order the waiving of rights to secrecy under the laws of a tax haven country. Moreover, the defence of bank secrecy laws of a country may not prevail where criminal prosecution proceedings for tax offence are initiated in the country of residence of the taxpayer.

20. However, it was recognized by the Group of Experts that the tax haven countries flourished primarily because of their insistence on non-disclosure of information to the countries of residence of taxpayers who used the facilities offered by tax havens. Such tax haven countries were not likely to enter into bilateral tax treaties with non-tax haven countries with provisions of exchange of information since their own existence as a tax haven would then be at stake. It was also noted that developed countries with their greater economic power and highly developed legal systems were in a better position, compared with the majority of developing countries, to deal with tax havens.

II. New financial instruments

21. The Group of Experts was briefed on the complex technical aspects of the new financial instruments by the Special Adviser to the Secretary of the Group of Experts. All financial instruments could be classified into three groups, namely, financial assets (stocks and bonds); options; and forward contracts. Options come in two forms: options to buy (call options) and options to sell (puts). A person may be either the holder of an option, being the person entitled to buy or sell; or the writer of the option, being the person

required to honour the holder's right to buy or sell. Since the obligation is not reciprocal, the holder usually pays a premium to the writer when the option is issued.

22. A forward is an agreement whereby one person agrees to buy designated property at a specified future date for a specified price and the other person agrees to sell. A futures contract is a kind of forward contract traded on an organized exchange and subject to the rules of the exchange. Options and forwards are known as "derivatives" since their values fluctuate with the value of the underlying property.

23. When developing domestic rules for financial assets and derivatives, it is necessary to maintain the internal consistency of the different types of instruments. Otherwise, taxpayers using derivatives for legitimate business purposes, primarily risk management, may find such uses upset by asymmetric tax treatments, while others may exploit these discontinuities to the detriment of tax revenues.

24. Derivatives have blurred the traditional lines of demarcation between capital gains and other income, realized and other gains, dividends and interest, and various other categories. To surmount these difficulties, tax laws may remove asymmetries and arbitrage opportunities by the elimination of all categories and the imposing of a tax on net accretions to wealth, which will not be practicable.

25. Broadly speaking, income from cross-border derivatives transactions can justifiably be taxed on a "residence" basis only and such income should not be subject to withholding taxes upon payment, from practical considerations. Since derivative transactions exploit very small margins, even a small withholding tax may far exceed the margin and make the derivative transaction uneconomical.

26. While the taxation of income from derivatives on a residence basis is detrimental to the interests of revenue of developing countries which are often the "source" countries, the sharing of revenues between developed and developing countries may not be feasible since the country from which the cross-border payments emanate is not usually the economic source otherwise than on the residence basis reported by the payer. However, source taxation of income from derivatives may be justified if a derivatives transaction is carried out at arm's length but at a price differing from the market price and a payment is made from one party to another to compensate for the divergence; this payment could be construed as a loan and the interest element implicit therein might be taxed as such. When derivative transactions are carried out between related parties, the pricing may not be at arm's length and withholding taxes on the excess payments would then be justified. In fact, legislation of the

United Kingdom of Great Britain and Northern Ireland on derivatives contains three anti-abuse rules directed at such transactions, with a specific provision presuming that a derivative transaction with a tax haven country will not be carried out at arm's length.

27. There is always a possibility of double taxation if a financial transaction is classified differently by two countries – if, for example, one country treats a swap as including an embedded loan and another uncovers no such loan.

28. Since most of the countries had not as yet crystallized the legal position regarding the tax treatment of income flowing from new financial instruments, the Group of Experts decided that it was premature to make specific recommendations on this subject and that the discussions at the meeting might be treated as exchanges of information.

III. Transfer pricing

29. The Group of Experts observed that the subject of transfer pricing was still undergoing the evolution begun in 1968 when the United States of America had issued extensive transfer pricing regulations on the basis of the arm's length principle. In fact, these regulations have closely followed the modifications brought about by the Organization for Economic Cooperation and Development (OECD).

30. Transfer pricing distortions were primarily intended to appreciably reduce the aggregate tax liability of group companies belonging to multinational corporations located in different countries and subject to multiple tax jurisdictions. However, non-tax factors, such as the need to shift income artificially between divisions for political reasons and transfer of income from subsidiaries to the parent company to better ensure organizational control, may also come into play.

31. Although both the United States regulations and OECD guidelines extensively relied upon the arm's length principle, its application was often difficult in cases where, for example, developing countries could not have access to comparable prices due to a limited range of markets for many goods and services and those countries also lacked the administrative resources required to audit transfer prices. Transfer pricing problems could, however, be dealt with on a bilateral basis through exchange of information.

32. Some developing countries experimented with alternatives to the adoption of the arm's length principle, such as, the presumptive tax and the net assets values tax,

which, in certain circumstances, became the minimum alternative tax. However, experience showed that these substitute mechanisms could lead to absurd situations – cases where, for example, loss-making companies were subject to excessive taxation.

33. Recently, the United States and other countries have initiated “advance pricing agreements” (APAs). Businessmen fear, however, that these agreements could be used to audit prior years’ cases. Moreover, the procedures of APAs are found to be time-consuming and costly for both taxpayers and the tax administration, there being an additional requirement of trained and efficient staff.

34. The suggestion for setting up of a multinational arbitration framework to help resolve transfer pricing issues was not considered feasible at the present juncture in view of several organizational and practical difficulties. Moreover, the Multilateral Arbitration Convention under the European Union has not reported any arbitration cases since 1996 when the Convention took effect. The technical assistance programme prepared by the United Nations is likely to enable developing countries to upgrade the skills of their tax administrators in this area of work.

IV. Update of the United Nations Model Double Taxation Convention between Developed And Developing Countries and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries

35. The Group of Experts took note of the fact that the General Assembly, had mandated, under subprogramme 8: Public economics and public administration: activities 7A.8 (a) (ii) (d), the updating and revision of the United Nations Model Double Taxation Convention between Developed and Developing Countries¹ and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries² referred to above.

36. The desirability of promoting greater inflows of foreign investment to developing countries under conditions that are politically acceptable as well as economically and socially beneficial has been adequately emphasized in resolutions of the General Assembly, the Economic and Social Council and the United Nations Conference on Trade and Development. Foreign private capital flows and investment play an important complementary role in the

economic development process, through the transfer of resources, managerial and administrative expertise and technology to the developing countries, and the expansion of productive capacity and employment as well as the establishment of export markets. The growth of investment flows from developed to developing countries depends, to a large extent, on the international investment climate. The prevention or elimination of international double taxation is a significant component of that climate. Under these circumstances, the necessity of updating and revising the United Nations Model Convention, after taking into account the changes brought about in international economic relations, cannot be overemphasized.

37. The basic objectives behind the update and revision of the United Nations Model Convention are establishing fiscal guidelines for trade liberalization and expansion with a view to releasing additional resources for sustainable growth and promoting tax harmonization. In the light of these objectives, the work of the Group of Experts is reflected, first, in the modifications brought about, over the years, in the model conventions of parallel organizations; second, in recent developed/developing country treaty practices, which have shown increasing sophistication; third, in the growth of an erudite critical literature in the field of international taxation; and fourth, in the comments of those who have negotiated and administered tax treaties under the United Nations Model Convention and those who engage in international trade and commerce with developing countries.

38. Before considering the revision of the Model Convention, the Group of Experts considered a report prepared by the International Bureau of Fiscal Documentation (IBFD) entitled “The United Nations model in practice.” (ST/SG/AC.8/1997/L.3). The report was based on an extensive research project carried out by W. F. G. Wijnen and M. Magenta of the Bureau in which 811 concluded treaties for the period extending from 1980 (when the United Nations Model Convention was published) to 1 April 1997 were scrutinized to ascertain whether they had adopted the distinctive provisions of the United Nations Model Convention. Of these, 697 treaties had been concluded by developing countries with developed countries or other developing countries and 114 treaties had been concluded between developed countries. The report indicated that there are 27 provisions of the United Nations Model Convention that are not found in or differ from the corresponding provisions of the OECD Model Convention. The study covered 26 of those provisions to determine whether each was included in the 811 treaties concluded since 1980. The study found that 6 of the 26 United Nations provisions were included in the large majority of the treaties

concluded by developing countries. It was deemed relevant to point out that the changes to the OECD Model Convention and commentaries since 1980 had been technical in nature, involving issues of application and interpretation rather than matters of fundamental substance, and it was necessary to consider whether these changes could be found useful within the context of developing countries. Accordingly, the IBFD study compared the relevant provisions of the United Nations Model Convention with those of the OECD Model Convention and identified the trends in treaty formulation arising from that comparison.

39. The Group of Experts agreed that the bilateral tax treaties were being negotiated in an environment that was in constant evolution within a rapidly changing world. The revised United Nations Model Convention would provide excellent guidance to the developing and transitional economy countries in the negotiation process.

40. The Group of Experts proceeded to discuss major changes that had been effected in other model conventions and other matters that should be considered in upgrading the United Nations Model Convention. In this process, the major consideration before the Group of Experts has been whether the changes proposed would result in greater equitable redistribution of allocable income and corresponding taxes and would thus ensure optimum and rational resource mobilization among all participants in international economic relations.

41. The Group of Experts noted that some of the bilateral tax treaties for the avoidance of double taxation contained provisions regarding assistance in the collection of outstanding taxes from assets located in the other contracting State, in pursuance of provisions in article 26 of the United Nations Model Convention relating to exchange of information. It was decided that the matter could be examined at length and that specific proposals in this regard should be brought before the Group of Experts at its ninth meeting.

V. Technical training

42. The Group of Experts noted that the phenomenal growth of international trade, commerce and international capital movements created complex and intricate problems of assessment and collection of proper tax liability in respect of incomes generated by international transactions. Tax administrators from developing and transitional economy countries encounter considerable difficulties in understanding the controversial taxation issues involved in,

for example, transfer pricing mechanisms and innovative financial instruments.

43. The United Nations has proposed that six interregional workshops in international taxation be organized to improve the technical skills of tax administrators of developing and transitional economy countries, including practical methods and strategies for combating tax evasion. The workshops will utilize the case-study method as well as lectures by experts in international taxation and finance. These workshops will also present opportunities for the participants to share experiences and points of view on tax systems prevalent in their own countries. These workshops, which will be of one-week duration and include about 25 participants from about 10 to 15 neighbouring countries, are to be held at Abidjan (Côte d'Ivoire), Accra (Ghana), Buenos Aires (Argentina), Kuala Lumpur (Malaysia), Moscow (the Russian Federation) and New Delhi (India). The costs of organizing these workshops may be shared by the United Nations, UNDP, host countries and other donors.

44. The Group of Experts emphasized the need for coordination of the proposed technical assistance programme with the efforts of other organizations.

VI. Recommendations

45. Bearing in mind the imperatives of the mandate of the General Assembly to bring about the update and revision of the United Nations Model Double Taxation Convention between Developed and Developing Countries and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries and the Group of Expert's deliberations on diverse subjects, the Group of Experts have made the following recommendations, specified below.

46. Tax havens are indulging increasingly in competitive reduction in tax rates or are offering immunity from taxation in order to attract financial resources from developed and developing countries, leading to loss of revenues. Tax havens have also been utilized by persons engaged in socially and morally reprehensible activities, such as drug trafficking, smuggling and money laundering. The United Nations and other organizations should enhance world awareness of the fact of the continuance of the tax havens phenomenon. Developed, developing and transitional economy countries through bilateral tax treaty negotiations should exert pressure on tax havens to

exchange information so as to reduce their efficacy and the reason for their existence.

47. Some multinational enterprises, while dealing with their associated enterprises for sale of goods, services and debt-service charges, have, through transfer pricing mechanisms, created an artificial basis for the determination of taxable profits which has resulted in distortions of market mechanisms. The United Nations and other multilateral organizations, such as OECD, should adopt a consensual approach and provide guidelines and strategies for dealing effectively with this phenomenon.

48. Innovative financial instruments have brought about avoidable complications in the taxation systems of both the developed and the developing countries. Serious efforts should be made by the United Nations and other parallel organizations concerned with this problem to lay down simplified guidelines and suggest necessary changes in fiscal legislation to avoid loss of revenue.

49. The advice provided by the Ad Hoc Group of Experts on International Cooperation in Tax Matters to the Secretary-General in international taxation issues, and particularly in the revision of both the United Nations Model Double Taxation Convention between Developed and Developing Countries and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries, is indeed noteworthy. The publication of both documents has been mandated by the General Assembly during the 1998-1999 biennium, pursuant to the report of the Secretary-General on United Nations reform: measures and proposals in respect of the proposed programme budget for the biennium 1998-1999. The Secretary-General should ensure that the proper guidelines and provisions in the United Nations Model Convention and the Manual for the Negotiation of Bilateral Tax Treaties are consistent with the interests of developed, developing and transitional economy countries and improve internal income allocation. The Secretary-General should also ensure that the proposed guidelines in the revised publications are simplified to meet the needs of tax administrators from the above-mentioned groups of countries and reflect conditions in the evolving international taxation environment.

50. To further promote this process and in view of the fact that tax administrators in developing and transitional economy countries are experiencing difficulties in international taxation, the Secretary-General will organize in Africa, Asia and Latin America

interregional training workshops to strengthen national capacities in international taxation issues and the negotiation of bilateral tax treaties. These seminars will be organized with the support of voluntary contributions.

51. The Group of Experts recommended to the Economic and Social Council for the biennium that the ninth meeting of the Group of Experts take place in the first half of 1999, as envisaged in the proposed programme budget for the biennium 1998-1999, so that the report of the meeting might be submitted to the Council at its substantive session of 1999 (July).

Notes

¹ United Nations publication, Sales No. E.80.XVI.3 and Corr. 1

² United Nations publication, Sales No. E.79.XVI.3.